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# Royal London Asset Management: Approach to secured credit

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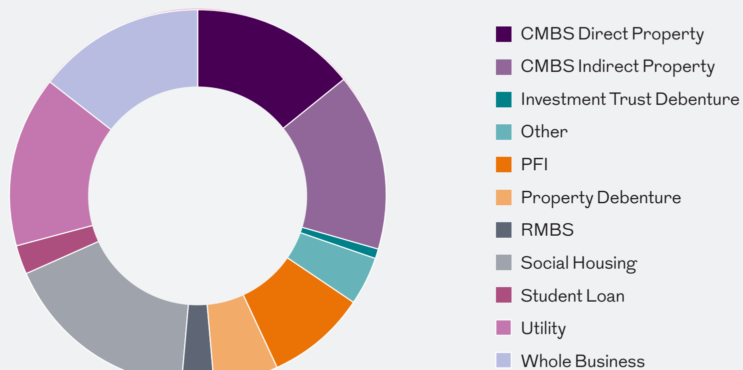
## Key points

- Secured lending has always been at the heart of our differentiated credit approach and forms the foundation for the majority of our credit solutions
- Security is a key credit enhancement – offering greater visibility and control to creditors in uncertain times
- Security as an attribute is under-appreciated and under-valued in a bond market that favours more superficial characteristics
- Not all security is equal and the idiosyncrasies have to be analysed and understood to avoid potential pitfalls
- Blending the best opportunities from secured corporate bonds & securitisations allows us to enhance portfolio fundamentals, diversity, and returns

Royal London Asset Management's journey through secured credit investment is neatly framed by our evolution. We have been investing in secured corporate bonds for over 30 years across a wide range of asset-rich sectors including infrastructure, social housing, investment trusts and commercial real estate – meaning an extremely granular range of issuers.

From this heritage, following the Global Financial Crisis (GFC), we extended our reach into the securitisation market by investing selectively across residential mortgage backed securities (RMBS), commercial mortgage backed securities (CMBS) and other asset backed securities (ABS). In the broadest of terms, secured credit represents a welcomingly diverse set of economic exposures with one critical commonality – a charge over assets.

Typical Secured Credit Allocation




Source: Royal London Asset Management 31 May 2024

## Benefits of security, and the research hurdle

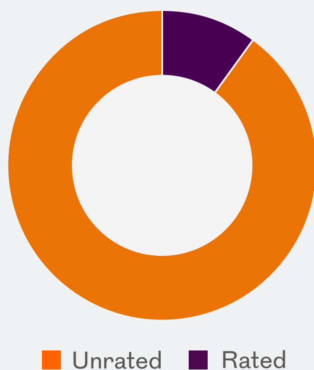
Security is a key credit enhancement, providing tangible backing to enhance bond recovery should a company default. However, its true value is more nuanced. By investing in bonds with the right type of security, both in terms of legal enforceability and appropriateness of collateral, dovetailing with protective covenants, such as early triggers that require issuers to supplement collateral pools as values fall, we can inject more dynamic protection into our credit portfolios. In an increasingly uncertain world, in an asset class with asymmetric risk and return profiles, the enhanced visibility and control from secured lending is hugely beneficial.

Equally, buying secured bonds is not a free ride. The analysis cannot be delegated and gaps in third-party ESG data must be plugged. Each bond is unique, whether due to the underlying assets or cashflows or different covenant packages and issuing structures. Accordingly, secured bond documentation is more complex and comprehensive than that for unsecured bonds; this is a good thing. What is more, as security and covenants are permanent over the life of the bond, the extra effort required to fully understand the investment is efficient. As a market leader in this area, with multi-cycle experience, the varying practical and commercial efficacy of different covenants and structures has become more plainly apparent.

## An evolving landscape

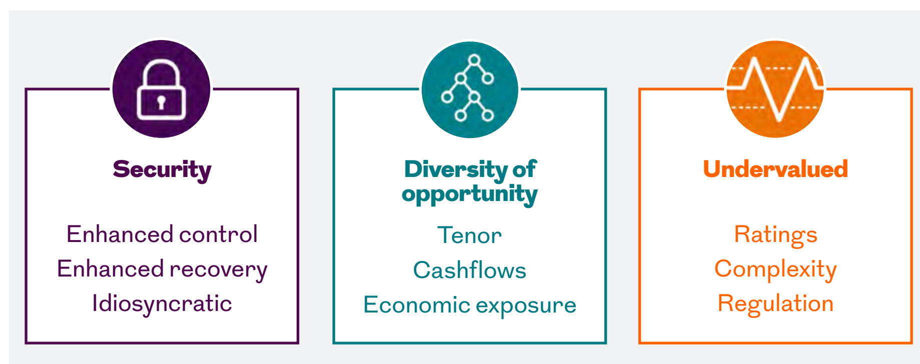
Whilst the origin of our secured lending was initially in the unrated market, at a time when investors favoured security over less fundamental protections, the clear majority of our secured bonds are now publicly rated and listed. Infrequently we may invest in a new unrated bond, assuming we can extract offsetting benefits, in which case we will apply our own long-established internal rating methodology.

Typical Secured Bond Allocation Rating





Building on a solid bedrock of investment in secured corporate bonds, over a decade ago we extended our expertise into the securitisation market, which hitherto had been perceived as a 'low risk' bank to bank market. Suddenly, forced selling into an unreceptive market provided a fantastic opportunity to add new exposures to bonds that for all their structural differences - ring-fencing of assets, floating rate coupons – simply represented another method by which corporates could raise secured financing. Critically, given some of the latent risks that we perceive in a now largely rehabilitated securitisation market – economic concentrations, over-rating of subordinated classes and extension risk – we can be highly selective in this area. Adding only the highest quality and highest conviction names and structures, supplementing our wider holdings of secured corporate bonds to enhance overall portfolio fundamentals, diversity, and returns. Contrast this with more recently established ABS funds. Often their narrower investment focus, perceiving securitisation as a separate asset class, means rating and return targets dictate ownership of the majority of deals, funnelled into concentrated consumer sectors with an emphasis on junior tranches.





## An exploitable market inefficiency

For all the fundamental advantages, the ultimate attraction of secured bonds is that these enhancements remain under-appreciated and undervalued in a market that has largely developed as a conduit for unsecured finance. Rating agency methodologies perpetuate this inefficiency by concentrating on probability of default rather than loss given default. Effectively, this means that rating agencies, as the largest arbiters of credit risk in the economy and embedded in control and regulatory frameworks across the globe, are telling investors that bond recovery following a default is an incidental issue. No wonder fundamental protections, such as security and covenants, are often overlooked. It is also remarkable that name recognition can count for more than a tangible claim on assets. How else can we explain a market that accepts a lower credit spread for unsecured lending to the UK retailer, Next PLC, than it does for secured lending to Sainsbury's.

Whilst the name of the secured bond, Longstone Funding, may not allow the lazy credit analyst to delegate their analysis, we feel the belt and braces protection of Sainsbury's cash flow generation, full amortisation of the bond removing bullet refinancing risk and ring-fenced collateral worth over ten times the value of the money we have lent more than compensates – even before acknowledging that we earn a higher credit spread for the privilege.

Lending well at the outset is a central tenet of our approach. Additionally, a useful outcome of lending with more pre-emptive control, as well as dampening the impact of unforeseen risks (e.g., poor governance, latent environmental liabilities), is that borrowers are required to negotiate with us early if performance deteriorates or they require amendments to restrictive bond terms. Therefore, on an ad hoc but not infrequent basis, bonds are redeemed early at prices above market levels to remove these borrowing restrictions.

| | Next plc £300M 3.625% 2028 | Longstone Finance £542.5m 4.791% 2030 |
|---|---|---|
| Rating | BBB | AAA |
| Benchmark | Yes | Yes |
| Security | Unsecured | First fixed charge on property |
| Asset Cover | n/a | >10x |
| Refinance | Bullet risk | Full amortising |
| Spread | 0.9% | 1.6% |

Portfolio characteristics and holdings are subject to change without notice. This does not constitute an investment recommendation.

For information purposes only.

Source: Royal London Asset Management, Bloomberg as at 31 May 2024.

## Case Study

The pre-Covid 19 acquisition of the pub company, Greene King, by the Hong Kong conglomerate, CKI, led to the early redemption of the one remaining bond in the Spirit Issuer plc whole business securitisation (5.472% 2028) in Sept 2022, at a material premium to the market price, as the new sponsor considered the rigidity of the structure to be inefficient given their relative unsecured funding costs.

Our bonds benefitted from a combination of free cash flow debt service cover ratios (DSCR) and limitations on asset withdrawals that countered CKI's financial objectives. Despite low leverage and strong freehold asset backing, the unconventional nature of the structure meant the bonds were rated sub-investment grade, allowing us to earn a significant yield premium verses unsecured yet more conventional consumer bonds. As well as providing bondholders with considerable control and visibility during a period of significant market volatility, an outcome that saw CKI pay a material premium to redeem the bonds contrasts sharply with the typically negative consequences of owning unsecured credit post M&A.

Most typically this is due to the borrower believing they can finance more efficiently in unsecured form or post M&A, where our covenants prevent the new owners of the borrower executing a leveraging strategy, and can provide additional incremental returns to well-constructed portfolios

With money increasingly diverted to investment grade corporate bonds as a standardised building block for portfolios – whether an insurance company requiring narrow matching adjustment eligibility or a central bank only buying bonds with certain superficial characteristics – the opportunity to create better credit portfolios by embracing the idiosyncrasy of bonds will persist. Secured lending has always been at the heart of our differentiated credit approach and the more the wider market commoditises, the more our experienced team are motivated to search out the quirks and the nuances of corporate bonds that can make a fundamental difference to portfolio risk and return.

## Contact us

For more information about our range of products and services, please contact us. Royal London Asset Management has partnered with FundRock Distribution S.A, who will distribute our products and services in the EEA. This follows the United Kingdom's withdrawal from the European Union and ending of the subsequent transition period, as UK Financial Services firms, including Royal London Asset Management, can no longer passport their business into the EEA.

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